Regular Meeting

Agenda Item #	2
Meeting Date	29 May 2007
Prepared By	Sara Anne Daines HCD Director
Approved By	Barbara B. Matthews City Manager

Discussion Item	Second Reading Ordinance Amending Takoma Park Code Section 6.20.060.C.8 to Eliminate Individual Financing Arrangements as a Factor in Rent Increase Awards
Background	In October 2006 the City entered into a contract with Kenneth Baar for services related to the review and recodification of *City Code Chapter 6.20 Rent Stabilization*. Dr. Baar's initial review, presented to the Council on November 20, 2006, included ten recommendations ranging from a change in the formula used to calculate the annual rent increase allowance to the exemption of certain rental facilities from regulations based on the number of units in the building rather than ownership. Of these initial recommendations, one - the application of available but unused rent increase allowances - has been withdrawn following further analysis of prior year rent reports. Another - an increase in the disclosure requirements for all rental housing real estate transactions - has been enacted with the amended ordinance having gone into effect April 9, 2007. The Council is asked to consider action on a third recommendation presented by Dr. Baar - the elimination of the consideration of the financing arrangements of individual landlords during the consideration rent increase petitions. Such action would result in the establishment of a uniform allowance for amortized expenses and the equalization of hardship rent increases for similarly situated landlords, regardless of whether they have a mortgage. If adopted, the amendment would become effective immediately following approval of the second reading. The Council will be provided an opportunity on Tuesday, May 29, to continue its discussion of current rent stabilization laws and to begin its review of more comprehensive legislative changes proposed by Dr. Baar, who will be present. The first reading ordinance was approved by the Council on May 21, 2007.
Policy	To inform and educate local landlords and tenants of their rights and responsibilities under the City of Takoma Park's various rental housing laws.
Fiscal Impact	N/A
Attachments	• Ordinance - Elimination of Individual Financing Arrangements as a Factor in Rent Increase Awards • *Issues and Options - Amendments to Takoma Park Rent Stabilization Ordinance (Preliminary Report - November 20, 2006)* by Kenneth K. Baar, Ph.D.
Recommendation	Accept ordinance at second reading.
Special Consideration	

Introduced by:

First Reading: May 21, 2007
Second Reading:

Drafted by: Kenneth Sigman
Asst. City Attorney
Draft date: May 17, 2007

Effective Date:

ORDINANCE NO. 2007-

Elimination of Individual Financing Arrangements as a Factor in Rent Increase Awards

WHEREAS, section 6.20.060.C.8 of the *Takoma Park Code* provides that, in calculating the amount of a hardship rent increase, the Commission on Landlord-Tenant Affairs is to adjust the base year net operating income for the inflation that occurred from the base year to the petition year; and

WHEREAS, for landlords who have not paid mortgage expenses between the base year and the petition year, the *Code* requires that the base year net operating income be adjusted by 50% of the general inflation rate, and, for landlords that have paid mortgage expenses, the base year net operating income is to be adjusted by 100% of the general inflation rate; and

WHEREAS, the rationale for allowing net operating income to increase at 50% of the inflation rate is that it should result in rent increases approximately equivalent to the historic average annual market rent increase and the City's annual rent stabilization allowance, which is 70% of the inflation rate; and

WHEREAS, the rationale for allowing net operating income to increase by 100% of the inflation rate for landlords without mortgage expenses is that increases in net operating income have a much smaller effect upon the cash flow of such landlords; and

WHEREAS, although the City has never received a Hardship Rent Increase Petition from a property owner that did not have a mortgage, the City recently has been advised that courts reviewing rent control statutes in California and New Jersey have found that the practice of allowing different rent increases for properties because of the financing arrangements of the landlords does results in arbitrary rent increases because a landlord's financing arrangements are not relevant to the value of the tenancy; and

WHEREAS, a landlord has taken issue with the favorable treatment that the *Code* provides to landlords without mortgages under the hardship rent increase petition process; and

WHEREAS, adjusting the base year net operating income by 50% of the inflation rate to calculate hardship rent increases is consistent with the City's current policy of allowing annual rent increases equal to 70% of the inflation rate, while adjusting the base year net operating income by 100% of the inflation rate is inconsistent with that policy; and

WHEREAS, the City wishes to ensure that its rent stabilization scheme does not result in arbitrary rent increases for tenants of properties where the landlord does not have a mortgage and does not place landlords that have mortgages at a competitive disadvantage;

NOW, THEREFORE, BE IT ORDAINED BY THE COUNCIL OF THE CITY OF TAKOMA PARK, MARYLAND:

SECTION 1. Title 6, Housing, of the *Takoma Park Code* shall be amended as follows:

Sec. 6.20.060 Rent increase petitions.

A. Definitions. In addition to the definitions set forth in Chapter 6.04, the following words and phrases shall have the following meanings:

~~"Actual and reasonable interest" means the annual percentage rate (APR) based on compounding interest methods using a constant annual interest rate percentage and a monthly payment schedule over the amortization period.~~

* * *

C. Rent Increases Pursuant to a Hardship Petition.

* * *

8. After the Commission' s adjustments to the landlord' s original figures listed on the petition, the Commission shall calculate the landlord' s base year net operating income by subtracting all allowable expenses approved for the base year from the landlord' s income during the base year. The Commission shall then make an upward adjustment of the base year net operating income by 50% of the Consumer Price Index in order to calculate the allowable petition year net operating income. If the landlord's petition year documentation shows that the petition year net operating income is less than the adjusted base year net operating income, the Commission shall allow rents to be adjusted upwards to result in a net operating income equal to the adjusted base year net operating income. ~~Landlords who have paid no mortgage expenses from the base year to the petition year shall receive an upward adjustment of the base year net operating income by 100% of the Consumer Price Index.~~

* * *

D. Petitions for Rent Increases for Capital Improvements.

* * *

6. Cost of Financing. The cost of financing a capital improvement shall be the ~~actual and reasonable amount of interest and other charges paid to the lender in connection with a loan taken to finance the capital improvement. The "actual and~~

~~reasonable amount of interest" shall mean the~~ interest the landlord would pay on a loan to finance the capital improvement with an annual percentage rate equal to the imputed interest rate set forth in subsection 7 ~~annual percentage rate (APR) based on compounding interest methods using a constant annual percentage rate and~~ with a uniform monthly payment schedule over the amortization period.

7. Imputed ~~Financing~~ Interest Rate. The interest rate to be used to calculate the cost of financing a capital improvement shall be ~~If a landlord has financed the capital improvement with her or his own funds, the cost of financing shall be deemed to be the amount of financing costs the landlord would have incurred had the landlord financed the capital improvement with a loan for the amortization period of the improvement, at an interest rate~~ equal to the prime rate in effect at the time of construction or installation of the capital improvement plus 2% per annum.

* * *

11. The following information shall be included in the petition for a rent increase pursuant to capital improvements:

* * *

~~c. If the landlord has acquired a loan to pay for the capital improvements, copies of loan agreements showing the interest payable on the loan and the amount paid by the date of the petition, if any;~~

~~d~~ c. If the landlord has spent his or her own labor installing or maintaining the improvements, a list of times spent and amounts billed for the labor.

* * *

~~E. Petitions for Rent Increases Due to Refinancing Costs or Interest Rate Changes.~~

~~1. Cost of Refinancing. Landlords shall be permitted to include in a rent increase petition the cost of refinancing a loan secured by the rental facility when the refinancing a loan secured by the rental facility when the refinancing is required due to the terms and conditions of the original loan or due to business necessity outside of the control of the owner(s). The cost of refinancing shall be amortized over the life of the new loan and included in a hardship petition pursuant to subsection (C) of this section.~~

~~a. The cost of refinancing shall include loan fees, document preparation fees and recording fees.~~

~~b. Landlords shall not be permitted to include in a rent increase petition the cost of refinancing a loan secured by the rental facility when the principal amount of the loan has increased, except where the increase in principal is due to the refinancing costs.~~

c. Landlords shall not be permitted to include in a rent increase petition the cost of refinancing a loan secured by the rental facility when the total of the principal, refinancing costs, other loan costs and interest payable over the life of the new loan is less than the total of the principal, loan costs and interest that would have been payable over the remaining life of the former loan.

d. A petition for a rent increase under subsection (E)(1) of this section shall be filed with the Commission within one year after the date on which the mortgage facility is refinanced.

2. Interest Rate Increases. If a landlord demonstrates that the interest rate on a loan secured by the rental facility has increased by 3 or more percentage points from the base year to the petition year, the landlord may include the interest expense on a hardship petition.

a. The portion of rent increases granted under this section shall be known as "rent surcharges" and shall be adjusted pursuant to changes in the interest rate on a mortgage secured by the rental facility.

b. The Commission shall not grant a rent surcharge due to an increase in the principal amount of the loan.

c. Rent surcharges granted under this section shall not form the basis of calculating maximum allowable rent, and rent increases granted under subsection (C), (D) or (E)(1) of this section and allowable under Section 6.20.020, rent stabilization allowance, shall be taken on the maximum allowable rent only.

d. Any rent surcharge granted under this section due to an increase in the interest rate on a loan secured by the rental facility shall be for the period of the loan interest rate adjustment, but not less than one year, and shall be adjusted pursuant to the period of the loan interest rate adjustment, but not less than one year, when the landlord demonstrates that the interest rate on the loan has not decreased to less than 3 percentage points above the interest rate paid on the loan during the base year. The rent surcharge shall be adjusted as follows:

i. If the interest rate remains within one percentage point of the interest rate in the petition year, the landlord may continue to charge the rent surcharge.

ii. If the interest rate on a loan secured by the rental facility decreases by one percentage point or more from the interest rate in effect during the petition year, the maximum allowable rents at the rental facility shall be maintained, and no rent increases shall be granted under this section or allowable under Section 6.20.020 shall be taken until the amount of the rent surcharge attributable to the interest rate decrease has been offset.

iii. If the interest rate again rises by more than one percentage point after an offset has been in effect pursuant to subsection (E)(2)(d)(ii) of this section the rent surcharge shall be adjusted upward accordingly by the amount attributable to the interest rate change. However, if the interest rate rises beyond the interest rate

~~in the petition year, no further extraordinary rent surcharges may be taken unless the landlord files an additional hardship petition.~~

~~iv. If the interest rate on a loan secured by the rental facility decreases to less than 3 percentage points above the interest rate paid on the loan during the base year, the maximum allowable rents at the rental facility shall be maintained and no rent increases shall be taken until all rent surcharges taken under this section have been offset. No further upward adjustments shall be made after the interest rate on the loan decreases to less than 3 percentage points above the interest rate paid during the base year unless the landlord files a subsequent hardship petition.~~

~~e. If the interest rate on the loan in the base year is computed using a different formula or method than is used to compute the interest rate in the petition year, the interest rate in the base year shall be recomputed using the same formula used to calculate the interest rate in the petition year. The recomputed interest rate shall be used to calculate the interest expense in the base year.~~

~~f. Notwithstanding the base year that has been established to calculate a hardship petition for the rental facility pursuant to subsection (C) of this section, the base year for the purposes of calculating a rent surcharge due to interest rate increases from the base year to the petition year shall be 1990 or the year the landlord acquired the rental facility, whichever is later.~~

SECTION 2. This Ordinance shall be effective immediately.

Adopted this _____ day of _____, 2007, by roll-call vote as follows:

Aye:
Nay:
Absent:
Abstain:

Note: Omitted text is indicated by asterisks. Deleted text is indicated by strikeout.

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PRELIMINARY REPORT - NOV. 20, 2006

Issues and Options
Amendments to Takoma Park Rent Stabilization Ordinance

Kenneth K. Baar, Ph.D.
Nov. 20, 2006

This report was commissioned by the City of Takoma Park. The opinions expressed herein are those of the author and do not necessarily represent the views of the City.

Executive Summary

The underlying premise for this analysis is that the rent stabilization ordinance should prevent excessive rent increases and preserve an affordable housing supply and at the same time permit rent increases that cover apartment owner operating cost increases and allow for reasonable growth in net operating income.

Since 1992, the City's rent stabilization system has authorized rent increases through 1) annual rent increases equal to 70% of the percentage increase in the CPI; 2) capital replacement passthroughs approved through a petition process; and 3) hardship (fair return) adjustments approved through a petition process. The hardship adjustments provide for growth in net operating income over base year levels. In addition, the City has had an inspection system in order to insure adequate housing conditions.

During this period, the owners of most of the apartment units in the city have relied solely on the annual rent increases, notwithstanding the availability of the other rent increase mechanisms. In light of the substantial increases in apartment operating costs during the past fourteen years, it is nearly certain that a significant portion of these owners have not obtained much growth in net operating income. From the perspective of the tenants of these buildings, while rents have increased in absolute terms, they have declined significantly relative to the cost of living.

At the same, a significant portion of owners have realized substantial rent increases through the capital replacement process without any consideration of the overall increases in their expenses relative to their proposed rent adjustments. As a result, capital improvement passthroughs may provide more or less than the rent adequate to provide a fair return.

This report recommends a number of reforms with the intent of creating a standard that provides a "surrogate" for a "reasonably operating market" and insuring a fair return, while at the same time protecting against excessive rent increases and the loss of an affordable housing stock. Under such a standard most owners would be able to cover operating costs increases and realize a reasonable growth in net operating income without having to resort to the petition process. The fair return system would provide increases in cases in which automatically allowable increases were inadequate.

Specific proposals for amendments and policy initiatives include the following:

1. **Annual Rent Increase**. An increase in the annual rent adjustment to 100% of the percentage increase in the CPI.

2. **Study of Utility Cost Increases of Takoma Park apartment owners**. A thorough analysis in order to determine actual utility cost increases based on the collection of utility expense data from all apartment owners as a part of the annual rent reporting process. On the basis of this analysis, the law could be amended to include a system of appropriate rent adjustments for owners who provide specified utilities.

3. **Repeal of the capital replacement passthrough**. Consideration of capital replacements as an amortized operating expenses within hardship (fair return) petitions, rather than as basis for separate rent adjustments.

4. **Limited Increases Upon Vacancies**. Consideration of limited increases upon vacancies (e.g. 5 to 10%) above the rent that would be permitted at the time of the vacancy, with a limit on the frequency of such increases (e.g. one every five years for a unit). In the event that the research demonstrates that utility cost increases have been substantial relative to rental income, possibly greater increases should be provided on a one time basis to owners who provide certain utilities.

5. **Uniform Interest Allowance for Amortized Expenses**. Under both the capital replacement and hardship (fair return) increase standards, the individual financing arrangements of owners are considered. Such provisions should be repealed. Instead, cost allowances particular types of expenses and permitted growth in net operating income should be uniform rather than dependent on the financing arrangements of each owner. The policy and legal rationale for this approach is explained in detail in Section II.D. of this report.

6. **Annual Registration Fee**. The adoption of an annual rent registration fee which is paid by apartment owners and passed through to tenants on a monthly basis. The fee would be used to provide additional funding for the Rent Stabilization Program. (A fee of $6 per month per apartment unit would provide approximately $200,000 per year.)

7. **Exemption Based on Number of Units on Property**. Exemptions based on the number of units in a property rather than the number of units that the landlord owns within the City.

8. **Unused Rent Stabilization Rent Increases**. When an apartment owner does not implement a rent increase in the year in which it is permitted, the increase may not be taken until the unit becomes vacant. This policy should be reconsidered. It acts as a disincentive for apartment owners to forego allowable rent increases, since it results in a "use it or lose it" situation. Also, the policy may act as an incentive to induce or harass tenants to vacate their apartments in situations in which there is a substantial gap between the rent that would be permitted if the apartment becomes vacant and the rent that can be charged to the current tenant.

9. **Alternate Base Year under Hardship Standard**. Provide hardship petitioners with the option of using the year 2000 as the base year in hardship petitions.

10. **Disclosure to Prospective Apartment Purchasers**. The establishment of a rent stabilization disclosure form that apartment building sellers would have to provide to prospective purchasers.

I. Background

A. The Rent Stabilized Housing Stock

60% of the rental units in the City are in thirty two buildings with twenty or more units. One-third of the units are in buildings with 50 or more units.[1] 52% of the rental units in the City were built between 1950 and 1969 and 16% were constructed in the 1970's. Only 24 units were constructed since 1990.[2] As of 2004, 697 of the 3,827 rental units licensed by the City were exempt from the rent stabilization ordinance.[3]

B. Rent Adjustments Under the Ordinance

1. Annual Across-the-Board Rent Increases

Since the City adopted rent stabilization in 1980, apartments have been subject to the following ceilings on annual rent increases:

(Table 1)
Annual Rent Increases

	Limit on Annual Increases
Sept.1981 -Aug. 1983	10%
Aug. 1983 - Sept. 1985	5%
Oct. 1986 - June 1990	4%
July 1990 - June 1991	5%
July 1991 - June 1992	4%
	70% of CPI
July 1992 - June 1993	2.7%
July 1993 - June 1994	1.8%
July 1994 - June 1995	2.1%

[1] Compilation based on data provided by City staff

[2] 2000 Census, Table H36 -Tenure by Year Structure Built (Summary File 3 (SF-3 - Sample Data)

[3] See City Staff Report, "Memorandum Rent Stabilization Recodification, July 9, 2004, p. 10 (on the web page of the City Council Worksession, Rent Stabilization Discussion, Feb. 14, 2005, pp.3-17, Agenda Item #7)

July 1995 - June 1996	1.3%
July 1996 - June 1997	1.5%
July 1997 - June 1998	2%
July 1998 - June 1999	1%
July 1999 - June 2000	1%
July 2000 - June 2001	1.5%
July 2001 - June 2002	2.3%
July 2002 - June 2003	1.7%
July 2003 - June 2004	1.8%
July 2004 - June 2005	1.9%
July 2005 - June 2006	2.1%
July 2006 - June 2007	2.8%

2. Capital Improvements Passthroughs

In addition, owners have been authorized to petition for rent increases to cover the amortized costs of capital improvements with an interest allowance. Capital improvements include painting and the replacements that are ordinarily undertaken in the course of maintaining the building.

From 1997 through 1999, only 47 petitions were filed.[4] In subsequent years the following number of petitions were filed: 2000-28; 2001-32; 2002-56; 2003-54; 2004-76; 2005-53.[5]

This preliminary report sets forth data on petitions from owners who filed two or more petitions from 2000 through 2005.[6] These owners filed 248 of the 299 petitions filed during this period. The petitions of these owners involved buildings with 982 units - approximately one-quarter of the rent

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[4] See City Staff Report, "Memorandum Rent Stabilization Recodification, July 9, 2004, p. 5, fn. 3 See City Staff Report, "Memorandum Rent Stabilization Recodification, July 9, 2004, p. 10. Worksession, Rent Stabilization Discussion, Feb. 14, 2005, pp.3-17, Agenda Item #7)

[5] See chart -"Capital Improvement Rent Increase Petitions" (1999-2005) (City Council Worksession, March 6, 2006, Agenda Item #5, p.3)

[6] The data is based on chart - "Landlords Filing Two or More Capital Improvement Rent Increase Petitions - January 1, 2000 - December 31, 2005 (City Council Worksession, March 6, 2006, Agenda Item #5, pp. 4-11)

controlled units in the city.

Owners of larger buildings were much more likely to file two or more petitions. Petitions were filed for less than 10% of the buildings with less than ten units, but were filed for one-half of the buildings with ten or more units.

A small group of owners filed a substantial portion of the petitions. Over half of the petitions were filed by eight property owners with 21 buildings containing 366 units.

(Table 2)

Capital Improvement Petitions by Owners who filed two or more petitions 2000-2005

		Bldgs.	Units	No. of owners
Cap. Imp. Petitions	No. of petitions			
All	248	74	982	39
Bldgs. 1-9 units	148	45	225	24
Bldgs 10-19 units	47	16	215	5
Bldgs 20 or more units	53	13	542	10
Owner filed over 10 petitions	137	21	366	8

The final report will include a detailed breakdown of all capital improvement petitions and a comparison of the buildings subject to capital improvement petitions with the overall stock of rent stabilized units.

3. Hardship (Fair Return) Increases

Owners are also permitted to apply for hardship increases. Under this standard, fair return is defined as base period net operating income adjusted 50% of the percentage increase in the CPI

since the base period. From 1992 through 2004, only five hardship petitions were filed.[7]

4. Legal Precedent

In states where rent controls are or have been widespread (New York, New Jersey, Massachusetts, and California), a substantial body of precedent has developed regarding constitutional standards for rent regulations. However, no precedent has been developed in Maryland.

Rent Ordinances must permit growth in net operating income

The principal legal doctrine has been that apartment owners must be permitted growth in net operating income. However, the courts have not indicated what rate of growth must be permitted.

In Helmsley v. Borough of Fort Lee,[8] the New Jersey Supreme Court considered the constitutionality of a regulatory scheme which limited annual general adjustments to 2 1/2% per year and had a slow and burdensome individual rent adjustment process. At the time of the case, there was substantial inflation and landlords were incurring substantial increases in operating costs.

The Court found that, as a result of this scheme, "the 'average' landlord can expect profits to fall for the indefinite future."[9] It held that "[a]t some point steady erosion of NOI becomes confiscatory."[10] In an accompanying footnote, the Court noted that: "We do not hold that keeping NOI constant (in current dollars) indefinitely is not confiscatory. The effect of such long-term stagnation of profits is not before us."[11]

Subsequently, in Fisher v.City of Berkeley, the California Supreme Court held that "indefinitely" freezing net operating income is confiscatory. The Court stated:

> ... although defendants' ordinance may properly restrict landlords' profits on their rental investments, it may not indefinitely freeze the dollar amount of these profits without

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[7] See City Staff Report, "Memorandum Rent Stabilization Recodification", July 9, 2004, p. 8.

[8] 394 A.2d. 65 (1978).

[9] 394 A.2d. at 76.

[10] Id.

[11] Id.

eventually causing confiscatory results.[12]

However, it did not define the terms "indefinitely freeze".

In Oceanside Mobilehome Park Owners' Ass'n v. City Oceanside[13] and Baker v. City of Santa Monica,[14] California appellate courts upheld fair return standards providing for growth in NOI at 40% of the rate of increase in the CPI. In 2005, in Berger Foundation v. Escondido, the Court of Appeal held that 100% indexing was not constitutionally required.[15] The Court explained that "... the use of indexing ratios [as opposed to 100% indexing] may satisfy the fair return criterion because park owners typically derive a return on their investment not only from income the park produces, but also from an increase in the property's value or equity over time.

II. Policy Issues

A. Annual Across-the-Board Rent Increases

Since 1992, annual rent increases have been limited to 70% of the percentage increase in the CPI, resulting in a total allowable rent increase of 31.3%.[16] During this period the CPI all items has increased by 44.7%.[17]

By virtue of the rent stabilization ordinance tenants are realizing substantial reductions in real housing costs, as well as being protected from excessive rent increases.

However, it is likely that the net operating incomes of landlords have been increasing at less than half of the rate of increase in the CPI, because a substantial portion of the cost increases would have been absorbed by increases in operating costs.

There is no systematic source of data on apartment operating costs within the City. However, the following hypotheticals illustrate why increases in net operating income may have been very limited.

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[12] 37 Cal.3d. 644 at 683 (1984).

[13] 157 Cal.App.3d.887; 204 Cal.Rptr.239 (1984).

[14] 181 Cal. App.3d. 972 (1986)

[15] 127 Cal. App.4th 1 (2005)

[16] This total is calculated by compounding the annual rent increases, rather than by adding the increases.

[17]

(In order to simplify the hypothetical it is assumed that the CPI has increased by 50%, rather than the actual rate of increase of 44%.)

Operating costs typically constitute half of the gross rental income of a building. It is likely that these costs would have increased by at least the rate of increase in the CPI due to the substantial increases in utility costs in recent years. In the case of a property in which base year rental income was evenly split between operating expenses and net operating income, during a time when the CPI increase was 50%, the allowable rent increase would be 35% and the growth in net operating income would be 20%.

(Table 3)
Growth in Net Operating Income
Rents Increasing by 70% of CPI
Operating Expense Assumptions:
oper. exp. half of gross income in base year
oper. exp. increased by CPI since base year

	Base Year	Current Year	Pct Inc.
CPI	100	150	50%
Rent	100,000	135,000	35%
Operating Expenses	50,000	75,000	50%
Net Operating Income	50,000	60,000	20%

In the case of a property with a base year net operating income equal to 60% of the rental income, during a period when the CPI increase is 50%, the growth in net operating income would only be 12.5% because most of the annual rent increase would be absorbed by cost increases.

(Table 4)
Growth in Net Operating Income
Rents Increasing by 70% of CPI
Operating Expense Assumptions:
oper. exp. half of gross income in base year
oper. exp. increased by CPI since base year

	Base Year	Current Year	Pct. Inc.
CPI	100	150	50%
Rent	100,000	135,000	35%
Operating Expenses	60,000	90,000	50%
Net Operating Income	40,000	45,000	10%

Under these circumstances, it would be appropriate to consider amending the annual increase provisions to authorize future increases equal to a higher percentage of the percentage increase in the CPI or 100% of the percentage increase in the CPI. If the inflation patterns of the past decade continue, 100% of CPI increases would result in annual increases about one percent higher than would be permissable under the current standard. (See table 1, above)[18]

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[18] **Annual Rent Adjustments Based on a Weighted Cost Study rather than the CPI**. In the course of discussions about annual rent increases it has been noted that the CPI all items is not a good measure of increases in apartment operating costs because the expenses associated with operating apartment buildings differ greatly from basket of household expenditures used to adjust the CPI all items. Out of recognition of this reality, some jurisdictions have used annual apartment operating cost studies (weighted cost studies) in order to determine allowable annual increases. These studies estimate the weight of each expenditure and the annual increase in that type of expenditure in order to calculate a total allowable rent increase.

In fact, when such studies are undertaken 1) about half of apartment rental income consists of net operating income which is adjusted by the CPI and 2) estimates of increases of a substantial portion of apartment operating costs - management and maintenance - are usually based on the CPI. As a result, the weighted cost index varies from the CPI for only about one-quarter of the allowable rent increase calculation. Nevertheless, such studies may generate more precise and reasonable annual rent adjustments. However, because such studies are complex and incomprehensible to many, their outcomes are often seen as magical and political, even if they are scientific. Furthermore, the body that must decide the allowable annual increase may act in either a scientific or "political" fashion in analyzing the data. In contrast, the annual CPI increase is immutable and undebatable.

B. Increases Upon Vacancies

The presence or absence of vacancy decontrol is a critical variable in a rent stabilization ordinance. Rent controls with vacancy decontrol protect current tenants, but do not insure the long term affordability of the rental housing stock. In the case of units with rents well below market rates, vacancy decontrols may act a disincentive to maintenance or even an incentive to undertake harassment to the extent these strategies will encourage a tenant to vacate the unit. Alternatively, owners may adopt the legal strategy of paying tenants to vacate their units.

As an alternative to vacancy decontrol, some rent control ordinances have permitted limited increases upon vacancies. Under the Washington D.C. ordinance, upon vacancies owners are permitted either a 10% rent increase or an increase up to the rent for a substantially identical unit in the same building, subject to a 30% cap on the increase.[19] Generally such standards limit the frequency of these increases. For example, under the West Hollywood ordinance that was in effect from 1983 through 1995, owners were permitted 10% increases upon vacancies, with the frequency of such increases limited to once every five years. [20] Typically, such provisions include a requirement that all vacancy increases must be reported to the Rent Board.

The vacancy increase provision could include procedures to monitor vacancies and deny increases in which the vacancy resulted from a reduction in maintenance and/or harassment.

Also, the vacancy increases could be restricted to units which have not obtained substantial rent increases based on capital replacements.

C. Additional Rent Increases for Apartment Owners who Pay for Utilities

Currently, all apartment owners are entitled to the same annual rent increases regardless of whether or not they pay for gas, electricity and/or heating. In the case of utilities paid by the landlord, small samples of data for different types of building indicate the following range of average ratios to gross income for utility expenses: heat 3.5% to 10%; electricity 3 to 6.3%.[21]

In the past decade there have been substantial increases and large upward and downward

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[19] D.C. Official Code, Sec. 42-3502.13 (Amended in 2006)

[20] In 1996, this provision was preempted to state law which mandated full vacancy decontrols for apartment rentals. Under a substantial number of the California ordinances that regulate the rents of mobilehome park spaces limited increases are authorized upon vacancies.

[21] Institute of Real Estate Management (IREM). Sample sizes: elevator buildings-5, garden buildings-12, low-rise 12-24 units-9, low-rise over 24 units-10, elevator buildings - 25

fluctuations in these expenses.[22]

Before rent controls were instituted differences in utility provision would have been reflected in the establishment of market rents and differences in rents among otherwise comparable units.

Clearly, apartment owners who pay for heat have been experiencing much greater cost increases than other owners and their tenants have been realizing greater savings than other tenants.

Adequate data on actual utility costs would provide the basis for the most rational policy.

Under these circumstances the following measures are recommended:

Proposed Measures Regarding Utility Expenses

1. A onetime (1 or 2) % rent adjustment for apartment owners who pay for heat.

2. A requirement that apartment owners who pay for gas, electricity, and/or heat provide several years of utility company bills and complete a utility expense information form as part of the annual rent registation. Compliance with this requirement should be a prerequisite to eligibility for future utility adjustments. Ideally this information would be required prior to the next annual rent registration which is due in Sept. 2007.

3. Tabulation of utility cost data in order to determine the average cost/rental income ratio for these utilities, the standard deviation from the average, and the distribution of cost ratios among buildings.

4. The adoption of one of the following types of regulations:

a) <u>standard utility cost adjustment</u> - a regulation tying annual utility costs adjustments to the average ratio of utility costs and their rate of increase. For example, if a particular type of utility expense (e.g. heat, gas, or electricity) was equal to 5% of rental income and increased by 15%, the

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[22] The CPI-Fuels and Utilities (1997=100) - Washington-Baltimore DC,-MD-VA-WV (Series Id: CUUSA311SAH2) increased from 100.8 in 1998 to 132 in 2004) The CPI-Electricity per KWH - Washington-Baltimore DC,-MD-VA-WV (Series Id: APUA31172610) increased from $0.072 in January 1998 to $0.112 in Sept. 2006). The CPI-Utility (piped) per gas therm -Washington-Baltimore DC,-MD-VA-WV (Series Id: APUA31172620) increased from $0.963 in January 1998 to $01.347 in Sept. 2006). Washington Gas Energy Services reported the following prices per therm: Nov. 2004 - $0.749; November 2005 - $1.69; October 2006 - $0.795. (Table: "Variable Pricing: Rate History" on website - wges.com)

Also see extensive data on utility costs in report to City Council, April 24, 2006, Agenda Item #8, pp. 47-63. The Section 8 utility allowance for gas heating increased from $13.00 in 2000 to $50.00 in 2006. (p. 57)

allowable rent increase to cover this cost increase would be .75% (5% x 15%) or

b) a passthrough of the actual cost increases for each building.

The advantage of the passthrough approach, as opposed to uniform utility adjustments based on types of services provided, is that it would provide for precise rent adjustments tied to the actual utility costs for each building. However, this approach has some significant drawbacks. It does not provide any incentive for energy efficiency since the owner would not realize any savings from lower utility bills. It would require extensive effort to determine and track and inform residents about the allowable rent adjustment for each property.

Uniform utility adjustments based on the services provided suffer from the shortcoming that they may be far less or more than adequate for individual buildings. But this approach would be much simpler to administer than the passthrough approach.

After utility cost data is collected, it will be possible to undertake a better evaluation of these issues.

D. Treatment of Mortgage Payments and Financing Costs

1. Consideration of Financing Costs Under the Hardship (Fair Return Net Operating Income) Standard

Under the fair return standard, under specified circumstances, consideration is given to increases in financing costs. In fact, these circumstances are very limited. One type of case is when an owner has refinanced for the same amount as the amount of the original loan and the refinancing is "required due to terms and conditions of the original loan or due to business necessity outside of the control of the owner(s). (Regulations Sec.26.1)

The regulations also provide for consideration of increased interest costs when the interest rate on the mortgage loan has increased by 3%. (Regulations, Sec. 27). In fact, this has rarely occurred.

The regulations also provide that an apartment owner is entitled to base period net operating income adjusted by 100% of the percentage increase in the CPI if the property is not subject to a mortgage, as opposed to the 50% standard applicable to all other properties.

2. Consideration of Financing Costs for Capital Replacements under the Current Standard

Under the capital improvement standard, consideration is given to actual and "reasonable" financing costs. In the event that a landlord has financed the improvement with his or her own funds financing costs are imputed at the prime rate plus 2%. (Regulations 24.4 (5)).

3. Treatment of Financing Costs

a. Policy Issues

Allowable financing costs should not vary depending on the particular financing arrangement selected by the owner or the particular circumstances of the owner. Instead, the allowable interest rate should be uniform. Otherwise, substantially differing rent increases may be authorized in different buildings for undertaking the same capital improvements, based on differences in financing.

Furthermore, under such a standard an owner has no incentive to obtain the most favorable financing terms; instead there is only an incentive to obtain financing that meets the "reasonable" standard. In addition, the standards regarding consideration of financing costs provide an invitation to manipulation. As a practical matter, an apartment owner could obtain financing that results in rent increases which are greater than those imputed for self-financing and then proceed to pay off the loan or obtain cheaper financing.

Also, owners who own their properties free and clear may obtain far greater hardship increases than other owners with comparable properties.

b. Judicial Doctrine

In any case, courts have repeatedly found that there is no rational basis for consideration of the particular financing costs of an owner in setting allowable rent increases. The constitutionality and rationality of considering debt service in a fair return formula first became a constitutional issue at the outset of rent controls in the 1920's. At that time, a New York appellate court ruled that allowable rent cannot depend on the mortgage arrangements associated with the property ownership.

> **We think it matters not, in determining the reasonableness of a rent charge, whether the property is mortgaged. Its rental value is no way affected thereby. ... If this were not the rule, there would be discrimination and the reasonable rental of one property would be larger than that of another, though the properties and their operating expenses were identical.[23]**

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[23] Hirsch v. Weiner, 190 N.Y.S.111,114 (1921, N.Y. Supreme Court, Appellate Term [in New York, the Supreme Court is an intermediate level court]).

In 1978, in a leading fair return case, the New Jersey Supreme Court expressed "serious reservations about the constitutionality" of a fair return standard which considered mortgage payments on the basis that such an approach leads to "inequitable results".

> **... we have serious reservations about the constitutionality of the Rent Leveling Board's method of computing just and reasonable return. The Board purports to allow a specified rate of return upon the landlord's net investment after payment of reasonable operating expenses and debt service. ... the permitted rate of return was equal to one percent plus the mortgage constant on the applicant's first mortgage. [fn. omitted] Reliance on the terms of the applicant's mortgage, rather than current financing terms, leads to inequitable results. For example, the Board ruled on two hardship applications in January, 1978, applying rates of return of 7.4% and 10.05% based upon the applicants' mortgage constants. Had both been allowed a 10% return, the first applicant would have received an additional $16,200. ...**[24]

The Court concluded that: "**Similarly circumstanced landlords ... must be treated alike. Discrimination based upon the age of mortgages serves no legitimate purpose."**[25]

Two California opinions have concluded that there is "no reason" for permitting landlords with larger mortgages to obtain higher rents.[26] In one of those cases, the California Appellate Court explained:

> **Palomar also complains that the City's formula refuses to treat interest expense on the debt incurred to purchase the parks as legitimate. This argument ignores the fact that the City's approach treats the total purchase price of the asset as the park owner's 'investment' rather than merely the amount of cash invested. Where the calculation of the park owner's return is based on the cost of the asset - normally a much larger figure - it makes no sense to deduct interest incurred to purchase the asset as an expense.**
>
> **Moreover, Palomar's version of the 'historic cost' formula means that an owner's fair return will vary depending on the financing arrangement. Assume two identical parks both purchased at the same time for $1 million each. Park**

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[24] Helmsley v. Borough of Fort Lee, 394 A.2d. 65,80-81 (1978).

[25] Helmsley v. Borough of Fort Lee, 394 A.2d. 65,80-81 (1978).

[26] Palomar Mobilehome Park Ass'n v. Mobile Home Rent Review Commission [of San Marcos], 16 Cal.App. 4th 481, 488; 20 Cal.Rptr.2nd.371, 374-375 (1993). Westwinds Mobile Home Park v. Mobilehome Park Rental Review Bd., 30 Cal.App.4th 84, 94 (1994).

A is purchased for cash; Park B is heavily financed. Under Palomar's approach, calculating return based on total historic cost and treating interest payments as typical business expenses would mean that Park A would show a considerably higher operating income than Park B. Assuming a constant rate of return, the owners of Park B would be entitled to charge higher rents than the owners of Park A. We see no reason why this should be the case.[27]

c. Proposed Standard - A Uniform Interest Allowance for all Owners

In line with the concept that all owners should be entitled to the same rent increases for the same capital improvements, a uniform interest allowance should be adopted. That interest allowance should be tied to interest rates for mortgages, because those rates reflect the interest rates for loans secured by real estate. For example, the allowable interest rate could be equal to the prime mortgage interest rate plus one or two percent as published in the weekly reports of Freddie Mac. This rate is available on the internet home page of Freddie Mac. A one or two percent addition to the prime rate is proposed because some apartment owners would have to obtain second mortgages to finance capital improvements; such mortgages would have a higher interest rate than first mortgages.

E. Capital Improvement Passthroughs

The current ordinance authorizes passthroughs for capital improvements without consideration of the overall income and expenses of the property. As indicated, the definition of capital improvement includes ordinary replacements and painting, which are standard in the course of operating apartment buildings. In most of the U.S. market conditions usually limit rent increases to the rate of increase in the CPI and apartment owners need to cover capital replacement costs within this framework.

Among rent controlled jurisdictions, some allow capital replacement passthroughs while others only consider capital improvement expenses in conjunction a fair return application. If capital replacements are not considered within the context of overall income and expenses, owners may be able to obtain capital improvement increases even though their rent increases are already more than adequate to: 1) cover increases in operating expenses, 2) cover the cost of the capital improvement, and 3) provide growth in net operating income.

The rationale for capital improvement passthroughs is that they provide an incentive for

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[27] Palomar Mobilehome Park Ass'n v. Mobile Home Rent Review Commission [of San Marcos], 16 Cal.App. 4th 481, 488; 20 Cal.Rptr.2nd.371, 374-375 (1993).

maintenance. Alternatively, they may simply provide a mechanism for obtaining rent increases for ordinary types of expenditures that would have been undertaken regardless of whether a passthrough could be obtained. These questions are old; however, they remain unresolved because there is no simple way of establishing which hypothesis is most accurate.

From a hypothetical perspective nearly all apartment owners would have qualified for capital improvement passthroughs within a five year period because they most certainly would have been required to undertake one or more of the types of maintenance or improvements that would have qualified for a passthrough in order to maintain their buildings.

In fact, from 2000 through 2005, owners obtained increases from more than one passthrough petition for only about one-quarter of the units and less than 15% of the buildings under regulation. Furthermore, as indicated, over one-half of the passthroughs obtained by owners who obtained more than one passthrough were obtained by eight apartment owners who had filed ten or more petitions. This outcome would lend to support to a conclusion that capital improvement passthroughs are obtained by apartment owners who have developed familiarity and expertise for going through the process, rather than only owners who have undertaken capital replacements.

As a practical matter, apartment owners may use the capital improvement passthrough mechanism as a tool to for maintaining net operating income or obtaining growth in net operating income through a process that is simpler than the hardship process.

A repeal of the broad capital improvement passthrough would be a logical step if it is accompanied by an increase annual rent adjustment and additional increases for master-metered utilities. If such a step is taken, the passthrough should still be retained for special circumstances, such as owners who have made substantial replacements in the six months prior to the amendment of the ordinance and capital improvements required as a result of changes in the law.

F. Hardship Standard

While very few hardship petitions have been filed, it is conceivable that a substantial number could be filed and that these petitions would result in a substantial rent increases. It is likely that the annual adjustments have not provided the rate of growth in net operating income that owners are entitled to under the hardship standard. Also, if the capital replacement provisions were repealed, it is possible that owners who are familiar with petition process would start filing hardship petitions.

Under the current standard, 1990 is the base year. In calculating base year net operating income owners may use actual income and expenses or may presume that net operating income equaled 40%

of gross income in the base year.[28] As an alternative, owners should be permitted to use 2000 as the base year with consideration of actual income and expenses. In any case, the 2000 base year net operating income would not be more than reasonable since it would reflect rent levels after eight years of a restriction on annual increases to 70% of the percentage increase in the CPI.

G. Adoption of an Annual Registration Fee and Petition Fees

The California jurisdictions which require annual registration of rent levels and provide extensive services to tenants (Berkeley, Santa Monica, and West Hollywood) standardly charge an annual administrative fee which is paid for by apartment owners and passed through to tenants on a monthly pro-rated basis. Prior to the adoption of state vacancy decontrol legislation in 1999, the regulations of these cities were distinct from the regulations of the larger California cities, because they did not provide for vacancy decontrols. The current annual registration fees in these cities are in the range from $125.

In the case of Takoma Park, an annual fee of $72 per year ($6.00 per month) per unit would generate revenues in the range $200,000 per year. This amount would be adequate to fund data entry and analysis, programming, mailing, and extra staffing and to offset some of the current expenses.

Currently, the annual expenditure for the Rent Stabilization program is in the range of $225,000 per year, approximately one percent of the annual city budget of $19 million. Typically, expenditures for rent stabilization programs have been very limited based on a view that they are less legitimate than other types of public expenditures. However, the current expenditure is very small when considered the important role that the program has in the lives of half of the City's population. Also, an expenditure of this size is tiny when compared with the per unit costs associated with creating affordable housing units through subsidy programs, which commonly range from $80,000 to $100,000 per subsidized rental unit.

In any case, additional funding is essential for undertaking the proposed data collection and analysis that would be associated with adopting a rent surcharge or passthrough for utility costs. Also, in the event that a limited vacancy increase allowance is adopted additional monitoring would be required. Furthermore, additional funding would provide resources for additional types of analyses which are invaluable for policy analysis. Some cost reductions would be realized if the capital replacement passthrough was repealed. However, the reductions may be offset by an increase in hardship (fair return) petitions.

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[28] The author needs additional information in order to determine how the 40% ratio compares with average ratios at that time.

H. **Exemption based on the Number of Units Owned**

The exemption for single units in the event that the landlord owns only that unit can easily be manipulated through paper transactions. Instead, any exemption standard should be based on criteria that cannot be manipulated (e.g. the number of units on the property)

I. Unused Rent Stabilization Rent Increases. When an apartment owner does not implement a rent increase in the year in which it is permitted, the increase may not be taken until the unit becomes vacant. This policy should be reconsidered. It acts as a disincentive for apartment owners to forego allowable rent increases, since it results in a "use it or lose it" situation. Also, the policy may act as an incentive to induce or harass tenants to vacate their apartments in situations in which there is a substantial gap between the rent that would be permitted if the apartment becomes vacant and the rent that can be charged to the current tenant.

K. Notice to Prospective Purchasers of Apartments

Interviewees indicated that often apartment purchasers were unaware of Takoma Park's rent regulations when they purchased their building. To the extent that the City has the power to adopt disclosure requirements in real estate transactions,

In the absence of such a requirement, brokers would still have a fiduciary duty to inform their clients of the existence of rent controls in Takoma Park. However, a disclosure requirement could establish the form of the notice and increase the likelihood that such disclosure will occur.